Office of Chief Counsel
Internal Revenue Service

memorandum

CC:NER:PEN:PHI:TL-N-1563-00
GAThorpe

date:

to: Group Manager E:1407/LBE

from: District Counsel, Pennsylvania District, Philadelphia

subject: [redacted]
EIN: [redacted]

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We are responding to your request for advice, dated March 14, 2000, in which you asked several procedural questions relating to the examination of the above taxpayer's income tax return for the period beginning on [redacted] and ending on [redacted].

ISSUE

Considering that the taxpayer merged with another corporation after the tax period in question, who will be liable for any tax deficiencies determined for any taxable periods predating the merger?[1]

[1] In addition to asking for advice on this issue, you also asked several questions about who has the authority to execute agreements and other documents on behalf of the taxpayer. We have already responded to those questions in a separate memorandum.

CONCLUSIONS/RECOMMENDATIONS

We believe that [redacted] is primarily liable for any tax deficiencies and additions to tax/penalties you determine for taxable periods predating the merger. But we do not believe that [redacted] is also secondarily liable for any pre-merger tax deficiencies and additions to tax/penalties as a transferee of property belonging to the taxpayer. Consequently, any statutory notice of deficiency should be captioned: [redacted], as successor to [redacted], and should include the full amount of any tax deficiency and additions to tax/penalties determined as a result of the examination.

We also believe that the taxpayer's former shareholders are secondarily liable as transferees for any tax deficiency or additions to tax/penalties you determine for the period under examination.[2] But you should not assert transferee liability against the taxpayer's former shareholders until you determine that you cannot collect the outstanding liability from [redacted]. Should you need to issue statutory notices of liability to the taxpayer's former shareholders, the captions should read: (transferee's name), as a transferee of property belonging to [redacted], and the amount of the liability asserted against each shareholder should be limited to the value of property received.

FACTS

Our understanding of the facts is based on your memorandum and the documents you subsequently provided. If our understanding of the facts is incorrect, please let us know immediately as it may affect the advice we have given.

The taxpayer, a Pennsylvania corporation, was a Subchapter C corporation until [redacted], when it filed a Subchapter S election. It filed a Form 1120 for the taxable period ending [redacted] and Forms 1120S for the short periods ending

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[2] It appears that [redacted], which was formed at the time of the merger to acquire the taxpayer's attest function, may also be liable as a transferee for any tax deficiency and additions to tax/penalties you determine the taxpayer owes. However, we do not have enough information to make that determination. If it paid less than adequate consideration for the assets it acquired, or if by contract it assumed any portion of the taxpayer's tax liability, then we believe that it would be liable as a transferee.

[redacted] and [redacted]. Before the merger, the taxpayer was an [redacted], which also provided management [redacted] services to its clients.

Sometime in [redacted], the taxpayer began negotiations with [redacted] (known then as [redacted]), a Delaware corporation, for the sale of the taxpayer's business to that company. On [redacted], the taxpayer, the taxpayer's shareholders, and [redacted] entered into a letter agreement providing for the merger of the taxpayer into a subsidiary of [redacted], [redacted], that would be formed under Ohio law solely for the purposes of the merger. The terms of the letter agreement, with minor modifications, were later incorporated into a more formal agreement entitled "Agreement and Plan of Merger," dated [redacted].[3] On [redacted], the taxpayer merged with [redacted], with [redacted] continuing as the surviving corporation.[4]

As provided in the agreements, on [redacted], through the taxpayer's merger with [redacted], effectively acquired the taxpayer's business for $[redacted], paying part of the purchase price in cash and the balance with its common stock. Instead of paying the purchase price directly to the taxpayer, [redacted] gave each of the taxpayer's shareholders his allocable share of the cash and stock (totaling $[redacted]), and stock worth $[redacted] was placed in escrow to be paid to the taxpayer's shareholders according to an "earnout formula" set forth in an exhibit attached to the agreements. The agreements provide that the taxpayer's shareholders' stock certificates would be immediately canceled following the closing date payment.

Neither [redacted] nor [redacted] assumed the taxpayer's debts, but rather the "Agreement and Plan of Merger" provides that the merger will have the effect prescribed by Pennsylvania and Ohio law. The agreements further provide that the parties intend the transaction to qualify as a tax-free

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[3] Both agreements provide that they will be governed by Ohio law.

[4] To comply with state law, a separate corporation, [redacted], was formed to take over the [redacted] part of the taxpayer's practice. Although this corporation is not a subsidiary of either [redacted] or its parent, it appears that those companies effectively control it through an administrative services agreement.

reorganization under I.R.C. § 368.

You are examining the short-year Form 1120S the taxpayer filed for the period ended [redacted]. At this point, you believe that you will be making adjustments which will create additional tax at the corporate level. Since, due to the merger, the taxpayer no longer exists, this raises a question as to who would be liable for any additional corporate income tax and any related additions to tax/penalties you determine the taxpayer owes.[5]

DISCUSSION

As a general rule, a corporation that acquires all of the assets of another corporation is not liable for the selling corporation's debts unless (1) the purchasing corporation expressly or impliedly agrees to assume the selling corporation's liabilities, (2) the transaction amounts to a consolidation or a merger, (3) the purchasing corporation is merely a continuation of the selling corporation, or (4) the transaction amounts to a fraudulent conveyance. See, e.g., West Texas Ref. & Dev. Co. v. Commissioner, 68 F.2d 77, 81 (10th Cir. 1933), rev'g 25 B.T.A. 1254 (1932). In cases like this where the taxpayer corporation merges with another corporation, the courts have held that the surviving corporation is primarily liable for the taxpayer's pre-merger tax liabilities if, under state law, the surviving corporation is liable for the merged corporation's debts. See Commissioner v. Oswego Falls Corp., 71 F.2d 673 (2d Cir. 1934), aff'g 26 B.T.A. 60 (1932), nonacq. 1932-2 C.B. 16. See also S. Pac. Transp. Co. v. Commissioner, 84 T.C. 387 (1985); Alexander Shokai, Inc. v. Commissioner, T.C. Memo. 1992-41, aff'd, 34 F.3d 1480 (9th Cir. 1994), cert. denied, 514 U.S. 1062 (1995); Missile Sys. Corp. of Texas v. Commissioner, T.C. Memo. 1964-212. For mergers subject to Pennsylvania law, "[t]he surviving or new corporation...[is] responsible for all the liabilities of each of the corporations so merged or consolidated," and the merged corporation's creditors can take the same action against the surviving corporation as they could have taken against the merged corporation if there had been no merger. 15 Pa.C.S.A. § 1929(b).[6] Consequently, we believe that [redacted] would be

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[5] To the extent the adjustments you make flow through to the taxpayer's former shareholders, you should follow the same procedures you would have followed had there been no merger.

[6] Although the agreements provide that Ohio law controls, we believe that this issue would be determined under Pennsylvania law because the taxpayer was incorporated under the laws of that

primarily liable for any tax deficiency or additions to tax/penalties you determine the taxpayer owes.

We have also considered whether [redacted] would be liable for the taxpayer's pre-merger tax liabilities as a transferee of property belonging to the taxpayer.[7] Under I.R.C. § 6901, if a person who receives property from a taxpayer/transferor is liable, in law or equity, for the taxpayer/transferor's debts, then the Service may assess and collect the taxpayer/transferor's tax liabilities from the transferee "in the same manner and subject to the same provisions and limitations as in the case of the taxes with respect to which the liabilities were incurred." Section 6901(h) defines the term "transferee" to include a "donee, heir, legatee, devisee, and distributee...." Treas. Reg. § 301.6901-1(b) expands this definition to include, among others, a shareholder of a dissolved corporation and the successor of a corporation that was a party to a § 368 reorganization. Ultimately, the question of whether a transferee is liable, in law or equity, for the transferor's debts is governed by state law (or some other provision of federal law). Commissioner v. Stern, 357 U.S. 39, 45 (1958).

Although the regulations indicate that the surviving corporation in § 368 reorganization may be a "transferee" subject to the § 6901 procedures, we do not believe that [redacted] is a "transferee" in this case. We believe that the definition in the regulations simply illustrates the types of persons who may be transferees subject to § 6901 and does not establish the liability of any of the persons listed. Rather, the Service must rely on some other provision of state or federal law as a basis for transferee liability. Stern, 357 U.S. at 42.

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state. However, we note that Ohio law contains a very similar provision, so we believe that the result would be the same even if we applied the law of that state. See OHIO REV. CODE ANN. § 1701.82(A)(4)(Anderson 1999).

[7] The fact that [redacted] is primarily liable for the taxpayer's pre-merger tax liabilities does not preclude its liability as a transferee. S. Pac. Transp. Co., 84 T.C. at 394-95; Alexander Shokai, Inc., T.C. Memo. 1992-41. Determining the proper theory upon which to base [redacted]'s liability is important because a notice based on the wrong theory would be invalid. Oswego Falls Corp., 71 F.2d 673; Missile Sys. Corp. of Texas, T.C. Memo. 1964-212.

Under the Uniform Fraudulent Conveyance Act, Pa.C.S.A. §§ 5101 et seq., a transferee of property may be held liable for the transferor's debts if the transfer was made to defraud the transferor's creditors (actual fraud), or if the transfer renders the transferor insolvent and was made for inadequate consideration (constructive fraud). Here, there is no evidence that the taxpayer entered into the merger to defraud its creditors. Moreover, the fact that [redacted] was statutorily liable for the taxpayer's debts, and presumably has sufficient assets to satisfy those liabilities, cuts against any argument that fraud was involved. Similarly, we do not think that the facts would support a finding of constructive fraud despite the fact that the merger, for all practical purposes, rendered the taxpayer insolvent. It appears that [redacted] provided adequate consideration for the assets it acquired from the taxpayer. Thus, even though [redacted] acquired all of the taxpayer's assets through the merger, we cannot rely on the Uniform Fraudulent Conveyance Act as a basis for asserting transferee liability against [redacted].[8]

[redacted] would also be liable as a transferee if it, by agreement, assumed the taxpayer's liabilities. S. Pac. Transp. Co., 84 T.C. at 394. However, none of the agreements we reviewed contained such a provision, but rather it appears that [redacted]'s liability for the taxpayer's debts is based solely on the state statute covering the effect of mergers.

While [redacted] is not liable as a transferee, we believe that the taxpayer's former shareholders are liable as transferees even though they did not receive any property directly from the taxpayer pursuant to the merger. Rather, the consideration, cash and stock in [redacted], was delivered directly to the shareholders, and their shares of the [redacted] stock were then canceled, making it appear as though the shareholders sold their [redacted] stock for cash and stock in [redacted]. However, in situations such as this, the courts have disregarded the form of the transaction and determined that the consideration (cash and stock in this case) was constructively received by the merging corporation and then distributed to its shareholders. Bates Motor Transp. Lines, Inc. v. Commissioner, 17 T.C. 151 (1951), acq. 1951-2 C.B. 1 (1951), aff'd, 200 F.2d 20 (7th Cir. 1952). See also Hunn v. United States, 60 F.2d 430 (8th Cir. 1932); Scott v. Commissioner, T.C. Memo. 1998-426. But see Vendig v. Commissioner, 229 F.2d 93 (2d Cir. 1956), rev'g 22 T.C. 1127 (1954). In other words, the courts, except for the Second

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[8] Since Ohio has also adopted the Uniform Fraudulent Conveyance Act, our opinion would be the same if we applied the law of that state.

Circuit, have treated these transactions the same as those involving the sale of the corporate assets followed by the dissolution of the selling corporation and the distribution of the consideration it received to its shareholders. There is no question that if the transaction here had been structured in that manner, the shareholders would be liable as transferees. See, e.g., Lime Cola Co. v. Commissioner, 22 T.C. 593, 605-06 (1954), acq. 1955-2 C.B. 7, 8. We believe that the courts, with the possible exception of the Second Circuit, would reach a similar result here. But since [redacted] is primarily liable for the taxpayer's tax liabilities, the Service should not assert transferee liability against the taxpayer's former shareholders until you determine that you will be unable to collect the outstanding liability from [redacted]. Wire Wheel Corp. of America v. Commissioner, 16 B.T.A. 737 (1929), aff'd, 46 F.2d 1013 (2d Cir. 1931).

Finally, we note that even though [redacted], [redacted]'s parent, was a party to the merger, it is not primarily liable for the taxpayer's pre-merger tax liabilities. Under state law, only the surviving corporation in a merger is liable for the merged corporations' debts. Here, [redacted] is the surviving corporation, and the statute does not extend its liability to its parent. Similarly, we do not believe that [redacted] is liable as a transferee because it did not receive any property belonging to the taxpayer, and, in any event, it appears that adequate consideration was given for the taxpayer's assets. Nor did it assume the taxpayer's liabilities in the merger agreement or in any other contract. Consequently, there is no theory upon which to assert liability against [redacted].

Since we anticipate that you will submit additional questions regarding this case, we have not closed our file. Should you have any questions about the advice we have given you in this memorandum, please contact Gerald A. Thorpe at (215) 597-3442. This memorandum has been submitted to our National Office under the post 10-day review procedures. Consequently, you should not rely on this advice until the 10-day review period expires.

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Assistant District Counsel